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Dame Meg Hillier MP
Chair of the Public Accounts Committee
Sent electronically

Dear Chair,

EQUIPMENT PLAN 2023-2033: UPDATE ON AFFORDABILITY

In my letter to you of 21 July 2023, I explained that the department would not provide a full Equipment Plan report this year, as we need to work through the direction from the Defence Command Paper 2023 (DCP23) and further understand the impact of extraordinary inflation and how to mitigate it[1]. A pause also provides us with an opportunity to review whether the current arrangements are best suited to an explanation of our forward equipment investment and support plans. This letter provides an update on the department's current understanding of the cost of the defence Equipment Plan.

This year we have been able to increase the budget allocated to the Equipment Plan by £46.3 billion to £288.6 billion over the ten years from 2023 to 2033. This reflects 49% of the forecast Defence budget. Against our current central budget assumption we forecast the cost of the Equipment Plan to exceed budget by just under 6%. There are however other reasonable scenarios in which the department has a surplus over ten years. The position reported here and by the National Audit Office (NAO) does not, for example, yet reflect the Government's commitment to increase defence spending to 2.5% of GDP as soon as economic and fiscal conditions allow. As in previous years, we have also set out a range of costs, reflecting uncertainty and risk. Different scenarios are therefore set out below to reflect potential budgetary and cost outcomes.

While we are currently forecasting a pressure, I am confident from an Accounting Officer perspective that the department can live within its equipment budget, with only 25% of the Equipment Plan committed over the next decade, providing the headroom to adjust the programme as needed and ensuring we can remain responsive to emerging events and new technologies. We have also made significant changes to how we manage the nuclear enterprise which will support us to deliver programmes related to the nuclear deterrent on schedule.

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[1] MOD PUS to Chair of the PAC, 21 July 2023. Equipment Plan

The enclosure provides continuity of financial reporting from previous years, including an update to the Project Performance Summary Table of major projects[2].

The NAO have again worked alongside us to review our plans and have published their report today. I want to thank them for their continued support on this work, which continues to help us improve our management of the Equipment Plan.

Fiscal, economic and policy context

You will be aware of the macroeconomic context in which we are working. For defence, this has meant managing inflationary cost increases and supply chain challenges. Inflation has added £10.9bn to the programme and foreign exchange movements a further £2.2bn, without which our financial position would be closer to that of previous years and our Equipment Plan pressure considerably smaller. Our commercial approach to seek non-index linked firm price contracting prior to the high inflation environment limited the initial impact, as well as our use of forward purchase of foreign exchange and long-lead items. We are now making greater use of index-linked contracts to reduce the risk of firms either applying high risk premia on firm price bids or not bidding.

This year the Chancellor announced a further £5bn for Defence at the Spring Budget. This included £3bn for the nuclear programme and £1.95bn for wider priorities. This was in addition to the £560m announced at last year's Autumn Statement for the department to invest in munitions and stockpiles. These are reflected in the position we are reporting. We have also baselined spend where agreed with HM Treasury.

This year the Government also published its refresh of the Integrated Review and the department published DCP23. The world is increasingly dangerous and the transition into a multipolar, fragmented and contested world has happened more quickly and definitively than anticipated in the original Integrated Review. Of relevance to the Equipment Plan, we announced our intent to invest £2.5bn in stockpiles over the next decade, which will allow us to improve supply chain resilience for munitions based on lessons emerging from the Ukraine conflict. However, as the Equipment Plan for 2023-2033 is based upon the department's ten-year position at the close of FY22/23, it does not reflect the policy intent set out within the DCP23 published this July. The DCP23 signals the department's shift to focus more on Artificial Intelligence, autonomous and digital capabilities to modernise our Armed Forces, and reinforces the importance of assuring our supply chains. It emphasises the importance of increasing our resilience by prioritising critical enablers such as logistical support, infrastructure, and stockpiles for complex weapons, general munitions and operational spares to ensure we can better deliver defence capabilities and credible deterrence across domains and meet the needs of sustained operation. While we recognise the affordability challenge of the 2023-2033 Equipment Plan, it is only right that the choices we make to address this challenge reflect the Government's priorities as set out in DCP23, including adapting to the lessons from the Ukraine conflict and ensuring that our equipment plan is relevant in a period of fast technological change. DCP23 was not aligned with a Spending Review, so while we can make some prioritisation choices

[2] Data is based on spending plans for equipment procurement and support at end of Financial Year 22/23, which were developed through our annual financial planning exercise.

now, we are also developing choices to reshape the plan under different scenarios for the next review. As I explained in my letter of 21 July 2023, this is part of our rationale for not publishing a full Equipment Plan report this year.

Defence Nuclear Enterprise

The Government has set up a new ringfenced budget for the Defence Nuclear Enterprise, which brings together for the first time the key programmes required across defence to ensure continued delivery of the nuclear deterrent. This new funding arrangement gives the department greater flexibility to move funding between years. This is a significant step forward which we expect to improve value for money in line with your committee's previous reports[3]. For example, we can now choose to bring capital funding forward to take advantage of an opportunity to purchase long-lead items in advance at a lower overall cost. This same funding flexibility also ensures that the rest of the defence programme is insulated from changes in the profile of nuclear spending, which includes many of our largest, most complex, and novel programmes. I have appointed the new Chief of Defence Nuclear as an additional Accounting Officer to support this.

We have also improved our understanding of the investment required to redress underinvestment over the past 20 years. We also need to accelerate delivery which will allow us to seize the benefits of the AUKUS partnership. This means we are reporting a higher cost for the nuclear enterprise, with investments now to support future capacity. The new nuclear funding settlement has largely funded these costs, reflecting the Government's commitment to delivering the nuclear deterrent.

There is a notional gap between the ten-year budget and the estimated costs for defence nuclear – some £7.9bn. This is some 7% of the budget over a ten-year period. The Department is not complacent and will act in successive planning rounds to ensure that costs are realistic, and projects are deliverable. Our experience of this financial year, as we start to accelerate projects within the nuclear ringfence, is that the uplift has proved sufficient to cover the increased scale of the programme. At the mid-year point in 23/24 we expect to deliver our nuclear projects and programmes within the allocated and ringfenced funding. No project has been delayed because of a shortage of funds and we are working hard to accelerate delivery. We are currently considering how we exercise the flexibility to bring forward or push back funding between 23/24 and 24/25.

Affordability of the Equipment Plan – Risk and Uncertainty

We have assessed the cost of the Equipment Plan on a comparable basis to last year. As ever, the figures outlined below are based on the position at the end of Financial Year 22/23. These forecasts include adjustments for expected future savings, efficiencies, and delivery constraints.

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[3] PAC, 2020, Defence Nuclear Infrastructure: 'Given its impact on the overall defence budget, the Department should make a case to the Treasury for ring-fencing the nuclear budget in the course of the discussions in 2020 for the current Integrated Review and the Spending Review'

	Cost	Planned spend	Pressure	Impact of inflation	Impact of forex
Nuclear EP	117.8	109.8	7.9 (7%)	+7.3	+0.4
Conventional EP	187.8	178.8	9.0 (5%)	+3.5	+1.8
Overall	**305.5**	**288.6**	**16.9 (6%)**	**+10.9**	**+2.2**

Figure 1: Headline financial position in the defence equipment plan

The total pressure in the Equipment Plan is £16.9bn, or just under 6% of the Equipment Plan, of which £10.9bn is due to inflation. The new nuclear ringfence arrangements mean that the remainder of the Equipment Plan is insulated from the impact of changes in the profile of nuclear spending. The non-nuclear element of the Equipment Plan has a pressure of £9bn or 5%.

We are forecasting increased costs for delivering the Future Combat Air System (FCAS) and the Navy's shipbuilding programme. FCAS costs increases reflect the tri-nation Global Combat Air Programme agreement between the UK, Japan and Italy which is based on an estimated cost share between the partner nations. We have included further risk provision in the middle of the decade to reflect higher levels of uncertainty in these costs.

In considering the affordability of the Equipment Plan over a ten-year period, the department must consider a range of budget scenarios beyond the end of the current Spending Review period. The baseline defence planning assumption set by HMT is 0.5% real annual growth in the core budget. The Government has said it will aim to increase Defence spending to 2.5% of GDP as soon as economic and fiscal conditions allow[4], however, the timetable for this commitment is uncertain. The higher scenario assumes we reach 2.5% by 32/33, starting from the expected post-SR period. Given the range of potential future scenarios, we have assumed a core scenario which includes additional funding for the nuclear enterprise but does not assume a path to 2.5%. This does not constitute an agreed long-term budget but is the scenario used for our affordability assessment. Figure 2 below shows the impact of these assumptions on the defence budget, Equipment Plan and overall pressure. In the best-case scenarios, the Equipment Plan is affordable over ten years, but would require spending plans to be reprofiled. In worst-case scenarios, the department will need to make significant savings across the period.

[4] Chancellor of the Exchequer, March 2023. Spring Budget Speech

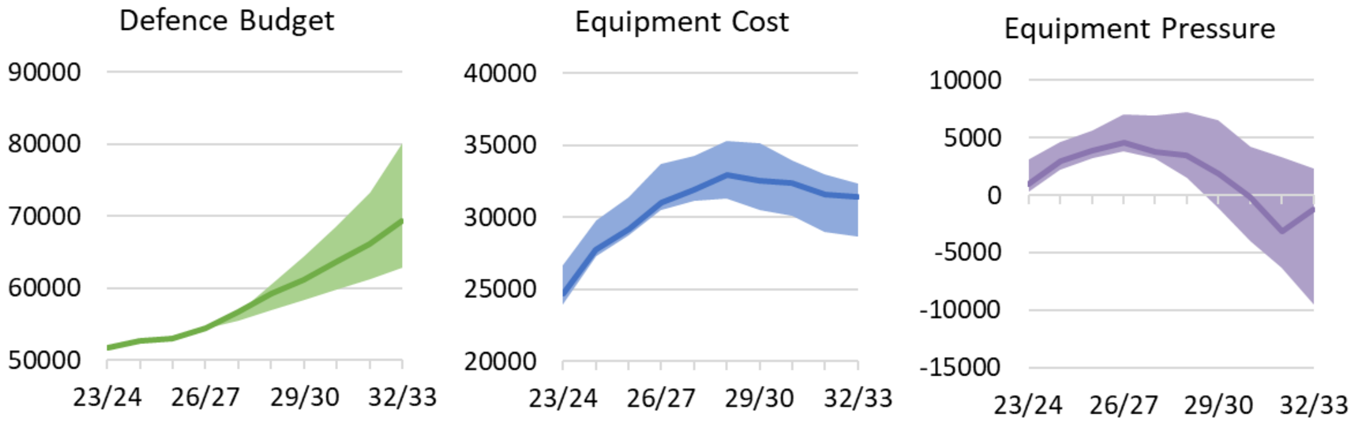


Figure 2: ranges of outcomes for cost and budget assumptions. Bold line reflects MOD core scenario. £m

Inflation will continue to be a significant risk and we have been taking action to reduce our exposure. For example, we have used bring-forwards where these de-risked the programme, we continue to forward purchase foreign currency, and we are maximising use of our contractual mechanisms. On the latter, we have adapted at pace by implementing a change to commercial policy to make greater use of index-linked fixed price contracts because in the current environment, firms may be unwilling to bid on a firm-priced (non-indexed-linked) basis or charge MOD a very high premium for doing so. These measures have and will mitigate some of the impact of inflation.

We have also seen increased uncertainty around deliverability. Supply chain constraints and the supply of skilled labour in both MOD and its suppliers have meant that delivery timetables are more uncertain than in previous years. The department has adjusted its forecasts by £18bn (6%) to account for these risks, but we think there is further risk, particularly in the nuclear enterprise, as discussed above.

The department's Cost Analysis and Assurance Service have again produced independent cost estimates covering approximately half of the equipment programmes in delivery. This year these independent estimates are in aggregate £1.5bn lower than our delivery team's assessments, principally because of expected delays to major programmes.

Foreign exchange continues to be a major source of uncertainty. Although the department continues to forward purchase USD and EUR to mitigate this risk, a scenario where GBP weakened by 20% would result in an additional £7.9bn cost to the 10-year programme. We have used a wider range of forex outcomes in our affordability analysis this year to capture this risk (up from +/- 10% range last year).

Finally, we have updated our reporting on our savings and efficiencies assumptions. These adjustments reduce costs by £4.9bn or 1.5%, lower than the £7.1bn or 2.7% assumed in last year's report. This year we have improved our reporting by more clearly distinguishing lower and higher maturity savings plans, addressing a key concern from previous reports. The value of less mature plans has reduced from £1.6bn to £1.2bn. We therefore assess the risk associated with these embedded savings and efficiencies to be lower than in previous reports.

Managing affordability

To ensure affordability, work is already underway to develop proposals to deliver the intent of DCP23 within our current budget. The additional funding from the Autumn Statement and Spring Budget is already allowing us to make new investments in stockpiles and munitions. In the Army, we are developing proposals which will allow us to modernise our forces by increasing investment in long-range fires, air defence, electronic warfare, Intelligence Surveillance and Reconnaissance (ISR), and logistics within current budget settlements. Funding constraints mean that to do this we will have to deprioritise or defer some existing programmes.

The department needs to prepare choices for different budget and cost scenarios, but it would be precipitous to cancel programmes now for decision in future Spending Reviews. To reduce the risk to value for money, the department is monitoring levels of contractually committed spend carefully and continues to operate a robust approvals framework to ensure new commitments do not constrain our ability to reduce costs in the future or to choose to fund different capabilities. We ensure that we maintain substantial uncommitted headroom over the period of the plan; on average 25% is currently committed.

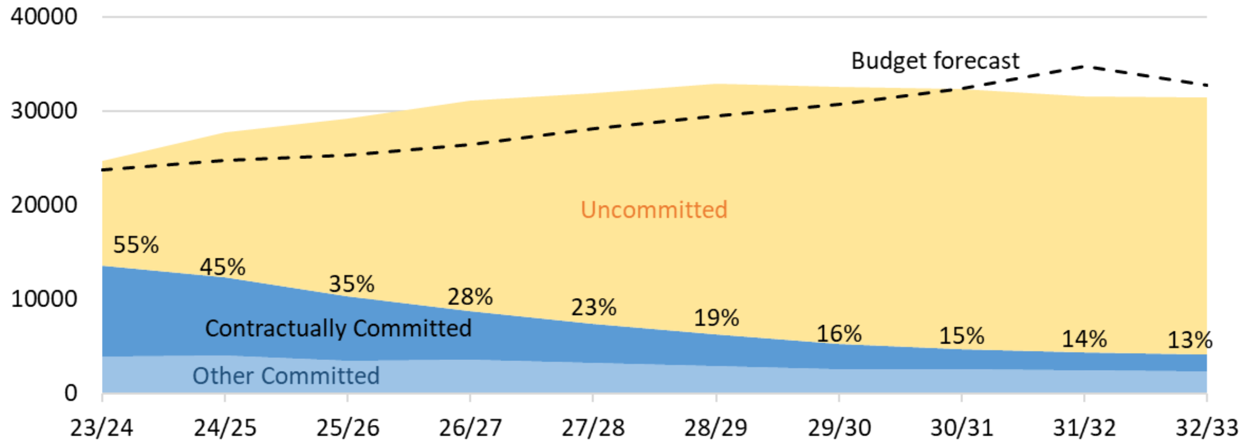


Figure 3: costs by commitment status in the Equipment Plan against budget, £m

We are also progressing with our ambitious acquisition reform agenda, which will build greater agility into our processes for prioritising and allocating resources. This means building in the financial headroom to respond to changing needs so we can iteratively develop capabilities and declaring ceiling costs to industry for new capabilities. We are also progressing the Sheldon Report's recommendations on amending the confidence levels used to assess milestone approvals dates; this will also have an impact on project costings within the Equipment Plan.

I would welcome the committee's views on how we best update on the department's equipment affordability position in the future. The format we introduced and have adapted since 2012 may no longer be suitable for the future given the significant changes to the funding mechanisms for the Defence Nuclear Enterprise; the difficulty of reporting a single, timely long-term position for a plan with volatile assumptions; and our ongoing work to reform Defence acquisition and reset our relationship with industry.

This letter and its enclosures will be published on GOV.UK. Copies will be placed in the library of the House of Commons and sent to the Chair of the Defence Select Committee and Comptroller and Auditor General.

Yours sincerely,

DAVID WILLIAMS

Annex A: Large Format Charts

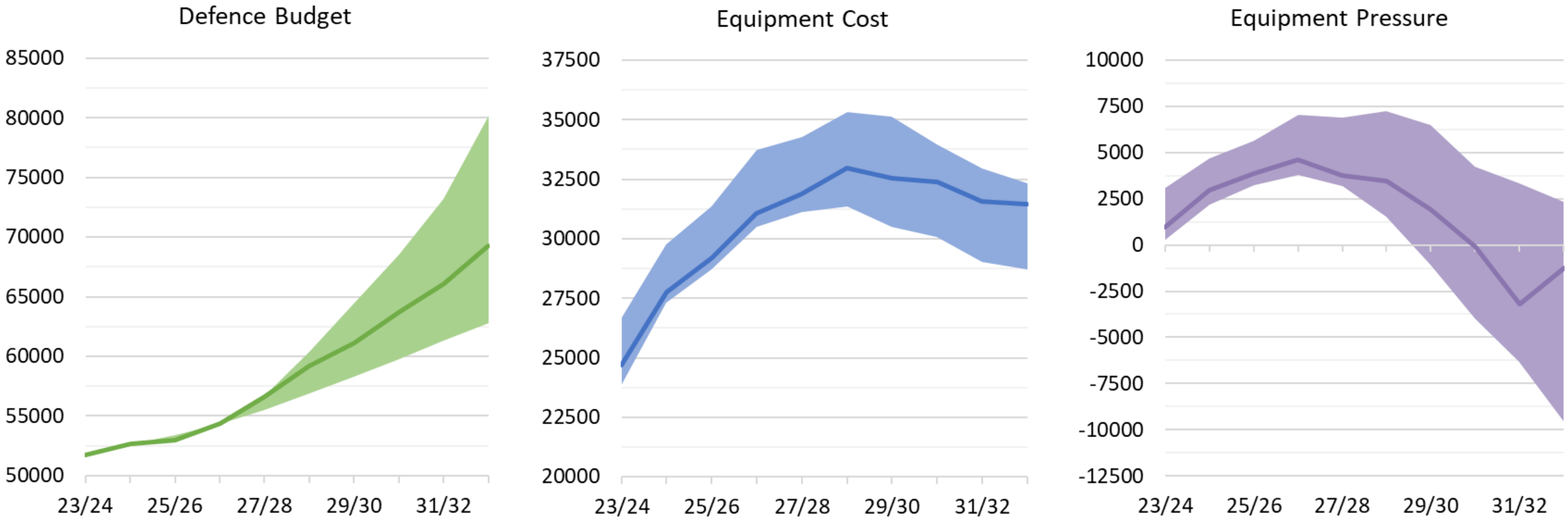
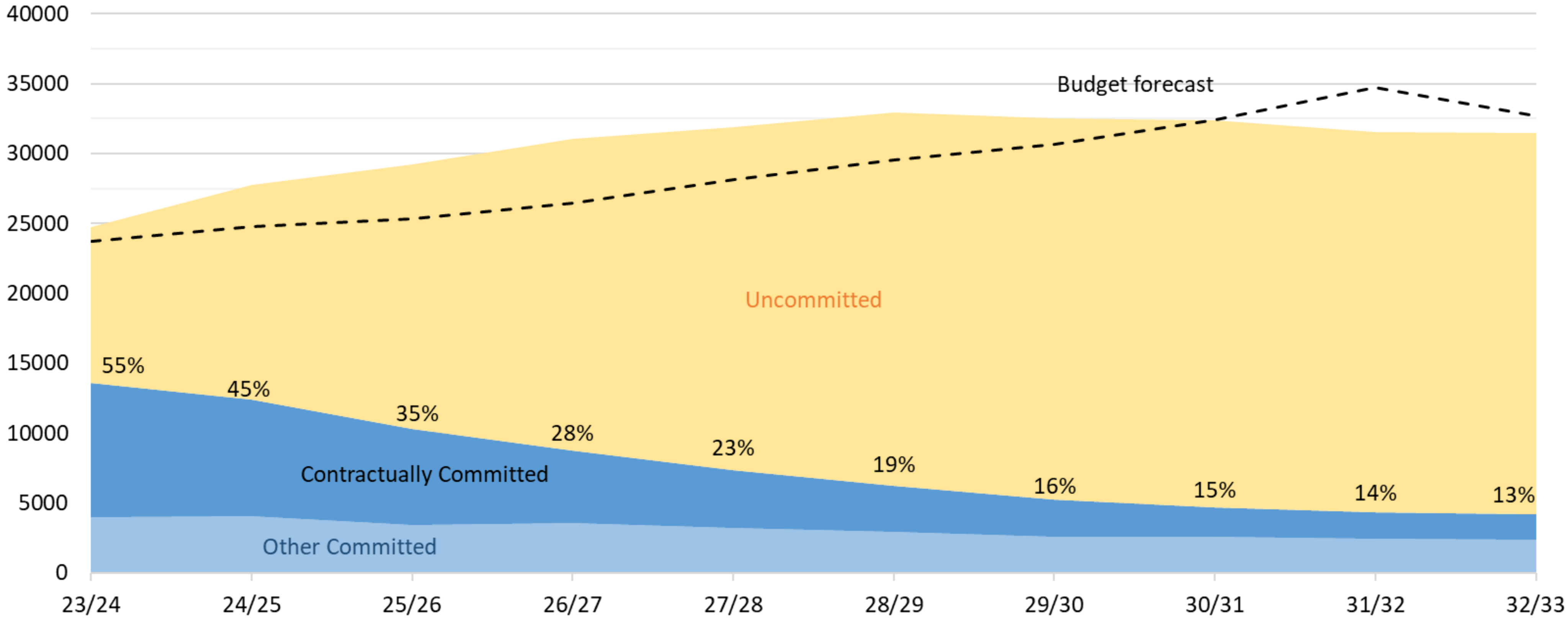


Figure 2: ranges of outcomes for cost and budget assumptions. Bold line reflects MOD core scenario. £m



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